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PAGE 01 OECD P 04268 01 OF 04 101900Z
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SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE
(EDRC) REVIEW OF ITALY

REF: (A) EDR(77)4; (B) ROME 1940

1. SUMMARY: IN REFDOC CIRCULATED FOR FEBRUARY 15,
EDRC REVIEW OF ITALY, SECRETARIAT NOTES THAT RECOVERY
BEGAN BRISKLY AT END 1975, BUT TAPERED OFF DURING 1976,
BROUGHT LITTLE IMPROVEMENT IN LABOR MARKET AND WAS
ACCOMPANIED BY SEVERE DETERIORATION OF ITALIAN CURRENT
ACCOUNT POSITION. SECRETARIAT STRESSES THAT INFLATION,
FED BY SELF-REINFORCING PROCESS OF PRICE/WAGE INCREASES
AND EXCHANGE RATE DEPRECIATION ACCELERATED DRAMATICALLY
IN 1976. GOI POLICY RESPONSE TO WORSENING OVERALL
ECONOMIC SITUATION WAS PROGRESSIVE SHIFT TOWARD RESTRIC-
TIVE DEMAND MANAGEMENT POLICY, CULMINATING IN OCTOBER,
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PAGE 02 OECD P 04268 01 OF 04 101900Z

1976 AUSTERITY PROGRAM. SECRETARIAT CONSIDERS DEMAND
MANAGEMENT POLICY RESTRAINT AS NECESSARY FIRST STEP
TOWARD STABILIZATION, BUT STATES THAT FUNDAMENTAL MODI-
FICATION OF WAGE INDEXATION SYSTEM (SCALA MOBILE) IS KEY
TO ACHIEVING LASTING IMPROVEMENT IN ITALIAN PRICE PER-
FORMANCE. SECRETARIAT INDICATES THAT DIFFICULTY OF ESTI-
MATING IMPACT OF OCTOBER STABILIZATION PROGRAM OF JANUARY

INDUSTRY-UNION AGREEMENT ON PRODUCTIVITY AND OF GOI "FISCALIZATION" MEASURES ADOPTED ON FEBRUARY 4 MAKE FORECASTING OF 1977 DEVELOPMENTS EXTREMELY HAZARDOUS. IN GENERAL, SECRETARIAT EXPECTS LITTLE OR NO GDP GROWTH, SMALL CURRENT ACCOUNT DEFICIT AND CONTINUED RAPID INFLATION. SECRETARIAT FEELS THAT AVOIDANCE OF CONSIDERABLE CHANGE IN EFFECTIVE EXCHANGE RATE SHOULD BE IMPORTANT PART OF STABILIZATION EFFORT. FOR MEDIUM-TERM, SECRETARIAT URGES THAT GOI TAKE MEASURES TO: (A) OVERHAUL PUBLIC SECTOR FINANCIAL SYSTEM AND (B) REDUCE RIGIDITIES AND DISTORTIONS IN SECTORAL AND REGIONAL PATTERN OF EMPLOYMENT AND LABOR COSTS.

ACTION REQUESTED: MISSION WOULD APPRECIATE COMMENTS/QUESTIONS WHICH COULD USEFULLY BE POSED AT REVIEW.

FOR ROME: MISSION WOULD WELCOME EMBASSY COMMENTS ON SECRETARIAT ANALYSIS AND RECOMMENDATIONS AS WELL AS PARTICIPATION OF EMBASSY REP IN REVIEW. END SUMMARY

2. SHORT-TERM PROSPECTS; DOMESTIC OUTLOOK: SECRETARIAT NOTES THAT STRONG RECOVERY FROM 1975-76 RECESSION WHICH BEGAN IN AUTUMN 1975 WAS LED BY REBUILDING OF INVENTORIES AND BY PRIVATE CONSUMPTION SPENDING (PRIMARILY CATCH-UP PURCHASES OF DURABLES). HOWEVER, CONSUMPTION AND INVENTORY GROWTH FELL OFF DURING YEAR, REAL FOREIGN BALANCE DETERIORATED AND DEMAND MANAGEMENT POLICIES BECAME MORE RESTRICTIVE WITH RESULT THAT ANNUAL RATE OF GDP GROWTH DECELERATED FROM 8 PERCENT IN FIRST HALF OF YEAR TO 3 LIMITED OFFICIAL USE

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PAGE 03 OECD P 04268 01 OF 04 101900Z

PERCENT IN SECOND HALF. SECRETARIAT PUTS AVERAGE YEAR-ON-YEAR GROWTH OF GDP AT 5 PERCENT, BUT NOTES THAT INCREASE IN EMPLOYMENT WAS MINIMAL SINCE INCREASE IN ACTIVITY WAS LARGELY REFLECTED IN INCREASE IN HOURS WORKED RATHER THAN IN HIRING.

3. AFTER LEVELING OFF IN 1975, INFLATION RATE ACCELERATED IN 1976. SECRETARIAT NOTES THAT OPERATION OF WAGE INDEXATION SYSTEM AS WELL AS WAGE INCREASES GRANTED UNDER RENEWAL OF COLLECTIVE AGREEMENTS WERE MAIN FACTORS LEADING TO 25 PERCENT RISE IN BASIC WAGE RATE IN INDUSTRY. SECRETARIAT STATES THAT IN SECOND HALF OF 1976, UNIT LABOR COSTS ROSE SHARPLY UNDER INFLUENCE OF AUTOMATIC WAGE INDEXATION FOLLOWING DOMESTIC PRICE EFFECTS OF LIRA DEPRECIATION AND OF SLOWDOWN IN PRODUCTIVITY GROWTH RESULTING FROM GENERAL DECELERATION IN ECONOMIC ACTIVITY. SECRETARIAT ALSO POINTS OUT THAT FEBRUARY, 1975 AGREEMENT TO REVALUE AS WELL AS TO FIX UNIFIED

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PAGE 01 OECD P 04268 02 OF 04 101907Z
ACTION EUR-12

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LIMITED OFFICIAL USE SECTION 02 OF 04 OECD PARIS 04268

"POINT VALUE" (AT LEVEL OF HIGHEST CATEGORY) FOR WAGE INCREASES UNDER INDEXATION SYSTEM HAS HAD EFFECT OF SIGNIFICANTLY INCREASING INFLATIONARY IMPACT OF INDEXATION. FINALLY, SECRETARIAT FINDS THAT DEPRECIATION OF LIRA AND HIGH DOMESTIC INFLATION HAVE BEEN MUTUALLY REINFORCING IN 1976 AND THAT THIS PROCESS HAS BEEN ACCELERATED BY THE SCALA MOBILE.

4. PROSPECTS FOR 1977: ACCORDING TO SECRETARIAT, MAIN FEATURE OF 1977 OUTLOOK IS ITS UNCERTAINTY. SECRETARIAT NOTES THAT (A) ACTUAL IMPACT IN 1977 OF RESTRICTIVE DEMAND MANAGEMENT POLICIES ADOPTED LAST OCTOBER IS DIFFICULT TO PREDICT; (B) EFFECT ON LABOR PRODUCTIVITY AND LABOR COSTS OF JANUARY AGREEMENT BETWEEN INDUSTRY FEDERATION AND LABOR UNION-AND OF NEW MEASURES ANNOUNCED BY THE GOVERNMENT IN EARLY FEBRUARY (INCLUDING PROPOSED "FISCALIZATION" OF CERTAIN SOCIAL CHARGES), IS HIGHLY UNCERTAIN. SECRETARIAT VIEW, HOWEVER, IS THAT THESE STEPS DO NOT CONSTITUTE FUNDAMENTAL CHANGE IN INDEXATION

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PAGE 02 OECD P 04268 02 OF 04 101907Z

SYSTEM AND THAT WAGE AND PRICE INCREASES WILL CONTINUE AT RAPID RATE THIS YEAR. SECRETARIAT FORECASTS 20 PERCENT RISE IN CPI FOR 1977 AS WHOLE, BUT WITH DECELERATION DURING YEAR. (SECRETARIAT MAINTAINS USUAL TECHNICAL ASSUMPTION OF NO CHANGE IN EFFECTIVE EXCHANGE RATE.) IN GENERAL, SECRETARIAT FEELS THAT SLOW GROWTH OF DOMESTIC DEMAND INDUCED BY RESTRICTIVE DEMAND MANAGEMENT POLICIES WILL BE OFFSET TO SOME DEGREE BY IMPROVEMENT IN REAL FOREIGN BALANCE AND BY MECHANICAL BOOST TO 1977 GROWTH FROM HIGHER THAN EXPECTED GROWTH IN SECOND HALF OF 1976. NET EFFECT COULD BE SMALL POSITIVE GROWTH OF REAL GDP (DECEMBER OECD "OUTLOOK" FORECAST IS FOR ZERO GROWTH). IN VIEW OF POOR GROWTH PROSPECTS FOR 1977, SECRETARIAT NOTES THAT LITTLE IMPROVEMENT IN LABOR MARKET CAN BE EXPECTED.

5. CURRENT ACCOUNT: SECRETARIAT INDICATES THAT MOVEMENT OF IMPORT VOLUMES LARGELY FOLLOWED THAT OF INVENTORY MOVEMENTS IN 1976, INCREASING EARLY IN YEAR, FALLING OFF TOWARD MID-YEAR, AND ACCELERATING SOMEWHAT AT YEAR END. IMPORT DEPOSIT SCHEME SURCHARGE ON PURCHASES OF FOREIGN EXCHANGE AND GENERAL SLOWDOWN OF ECONOMIC ACTIVITY ALSO HAD DAMPENING EFFECT ON IMPORT VOLUME GROWTH. IMPORT PRICES ROSE STRONGLY (30 PERCENT IN LIRA TERMS BETWEEN FOURTH QUARTER OF 1975 AND THIRD QUARTER OF 1976) DUE TO DEPRECIATION OF LIRA. ACCORDING TO SECRETARIAT'S PROVISIONAL ESTIMATES, EXPORT VOLUMES INCREASED STEADILY THROUGHOUT 1976, DESPITE LOSS OF MARKET SHARES BY ITALIAN EXPORTERS. SECRETARIAT ATTRIBUTES LOSS OF MARKET SHARES IN FACE OF LIRA DEPRECIATION TO INCREASINGLY WIDESPREAD PRACTICE ON PART OF ITALIAN EXPORTERS TO FIX EXPORT PRICES IN FOREIGN CURRENCY. IN ADDITION, SECRETARIAT ALSO NOTES THAT IMPORT DEPOSIT SCHEME MAY HAVE IMPEDED EXPORTS SINCE LATTER HAVE HIGH IMPORT CONTENT. SECRETARIAT ESTIMATES 1976 CURRENT ACCOUNT DEFICIT OF \$3.5 MILLION.

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PAGE 03 OECD P 04268 02 OF 04 101907Z

6. SECRETARIAT OBSERVES THAT RAPID INFLATION, DETERIORATING CURRENT ACCOUNT POSITION AND POLITICAL UNCERTAINTY CONTRIBUTED TO DOWNWARD PRESSURE ON LIRA LAST YEAR. MEASURES TO REDRESS SITUATION INCLUDED (A) PROGRESSIVE TIGHTENING OF MONETARY POLICY, INCLUDING IMPOSITION OF CEILING ON BANK CREDIT; (B) PRIOR DEPOSIT SCHEME; (C) SURCHARGE ON FOREIGN EXCHANGE PURCHASES AND (D) HEAVY INTERVENTION IN EXCHANGE MARKET. SUBSTANTIAL FOREIGN BORROWING LED TO INCREASE IN GROSS RESERVES FOR

YEAR AS WHOLE AND FOREIGN INDEBTEDNESS REACHED \$17
BILLION BY NOVEMBER.

7. IN DECEMBER "OUTLOOK" SECRETARIAT HAD FORECAST RETURN
TO CURRENT ACCOUNT EQUILIBRIUM IN 1977. SECRETARIAT
EXPECTS GROWTH TO BE EXPORT-LED IN 1977, BUT NOTES THAT
UPWARD REVISION IN DECEMBER GROWTH FORECASTS IMPLIES THAT
SMALL CURRENT ACCOUNT DEFICIT COULD WELL MATERIALIZE.

8. ECONOMIC POLICY: WITH ONSET OF ACCELERATING INFLA-
TION AND WIDENING CURRENT ACCOUNT DEFICIT, GOI ECONOMIC
POLICIES MOVED INCREASINGLY TOWARD RESTRICTION AND CUL-
MINATED IN "AUSTERITY PROGRAM" WHOSE DEMAND MANAGEMENT
POLICY ASPECTS WERE ANNOUNCED IN OCTOBER, 1976. SECRE-
TARIAT TRACES ITALIAN PROGRESS IN ADHERING TO FISCAL
RESTRICTIONS SET BY EC IN MARCH, 1976 LOAN AGREEMENT.
ON ASSUMPTION THAT TREASURY CASH DEFICIT DID NOT WORSEN

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PAGE 01 OECD P 04268 03 OF 04 101909Z
ACTION EUR-12

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LIMITED OFFICIAL USE SECTION 03 OF 04 OECD PARIS 04268

IN FINAL MONTHS OF 1976, SECRETARIAT ESTIMATES THAT
CEILING FOR THIS DEFICIT WILL ONLY SLIGHTLY EXCEED EC
NORMS (I.E., 14,600 VS. 13,800 BILLION LIRA), BUT THAT
CENTRAL BANK FINANCING OF TREASURY DEFICIT REACHED 6,000
BILLION LIRA IN FIRST HALF OF 1976 COMPARED WITH ESTAB-

LISYRD CEILING OF 5,700 BILLION LIRA FOR ENTIRE YEAR. NEVERTHELESS, SECRETARIAT ESTIMATES THAT OVERALL FINANCING REQUIREMENT OF PUBLIC SECTOR WILL BE SAME AS IN 1976 (10,400 BILLION LIRA) AND WILL THUS DROP FROM 9 PERCENT IN 1976 TO 7.6 PERCENT OF GDP IN 1977.

9. SECRETARIAT SKETCHES OUTLINE OF BUDGETARY PROVISIONS OF OCTOBER AUSTERITY PROGRAM AND STATES THAT PROGRAM COULD GENERATE INCREMENTAL TAX REVENUE OF 4,750 BILLION LIRA, OR 3 PERCENT OF GDP FORECAST FOR 1977. SECRETARIAT FEELS THAT TREASURY'S 1977 CASH DEFICIT COULD BE AS LOW AS 9,700 BILLION LIRA AND ACCEPTS GOI PROJECTION OF 9,700 BILLION LIRA PUBLIC SECTOR FINANCING REQUIREMENT, BUT NOTES THAT THESE AMOUNTS COULD EASILY BE EXCEEDED. LIMITED OFFICIAL USE

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PAGE 02 OECD P 04268 03 OF 04 101909Z

10. SECRETARIAT STATES THAT INCREASINGLY RESTRICTIVE MONETARY POLICY IN 1976 WAS ALSO IN LINE WITH AGREEMENTS MADE WITH EC (28,500 BILLION LIRA CEILING ON DOMESTIC CREDIT EXPANSION). NEVERTHELESS, SECRETARIAT NOTES THAT MONETARY BASE (NOT DEFINED IN REFDOC) EXPANDED RAPIDLY DURING MOST OF YEAR, LARGELY DUE TO MONETARY FINANCING OF TREASURY DEFICIT. SECRETARIAT ESTIMATES THAT APPROXIMATELY 4,000 MILLION LIRA WERE STERILIZED UNDER IMPORT PRIOR DEPOSIT PROGRAM, BUT SUGGESTS THAT RESTRICTIVE EFFECTS OF SCHEME WERE PARTLY OFFSET BY CAPITAL INFLOWS AND THAT RAPID EXPANSION OF DOMESTIC CREDIT LED, IN NOVEMBER, 1976, TO IMPOSITION OF LIMITS ON BANK CREDIT IN EFFORT TO STAY WITHIN EC CEILING. SECRETARIAT DOES NOT COMMENT ON PROSPECTIVE EVOLUTION OF MONETARY POLICY IN 1977.

11. CONCLUSIONS: RELEVANT PORTIONS OF CONCLUSIONS WILL BE TRANSMITTED SEPTEL FOR WASHINGTON AGENCIES' (AND ROME'S COMMENTS. IN THIS CONNECTION MISSION WOULD POINT OUT THAT EDRC IS NOT A CONSENSUS COMMITTEE IN SENSE THAT INDIVIDUAL COUNTRIES CAN INSIST ON USE OF SPECIFIC LANGUAGE. SIMILARLY, INDIVIDUAL COUNTRIES CANNOT BE HELD RESPONSIBLE FOR HAVING APPROVED DOCUMENTS IN EVERY DETAIL. THUS, EDRC WILL NOT UNDERTAKE LINE-BY-LINE DRAFTING SESSION ON CONCLUSIONS; THIS EXERCISE WILL BE LEFT TO BILATERAL MEETINGS BETWEEN SECRETARIAT AND ITALIANS. EDRC, HOWEVER, WILL BE ASKED TO APPROVE THRUST OF CONCLUSIONS, AND WE SHOULD THEREFORE TRY TO INSURE THAT SECRETARIAT ANALYSIS AND POLICY RECOMMENDATIONS ARE CONSISTENT WITH WHAT U.S. WOULD CONSIDER APPROPRIATE AT THIS CRITICAL JUNCTURE IN ITALIAN SITUATION.

12. COMMENT: (A) SECRETARIAT STRESSES THAT DEPRECIATION

AND INFLATION WERE MUTUALLY REINFORCING IN 1976 AND THAT
THIS CUMULATIVE PROCESS WAS ACCELERATED BY WAGE INDEXA-
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PAGE 03 OECD P 04268 03 OF 04 101909Z

TION. MISSION WOULD POINT TO FALLACY OF VICIOUS-CIRCLE
HYPOTHESIS AND EMPHASIZE CENTRAL ROLE OF DOMESTIC POLICIE
IN BRINGING ABOUT DOMESTIC AS WELL AS EXTERNAL STABILITY
MISSION WOULD ARGUE THAT SHARP INCREASE IN "POINT
VALUES" (SEE PARA 3) WAS A MAJOR SOURCE OF INFLATIONARY
PRESSURE AND WAS UNRELATED TO EXCHANGE RATE MOVEMENTS;
(B) IN THIS CONNECTION, MISSION WOULD ALSO QUESTION SEC-
RETARIAT RECOMMENDATION THAT ITALIANS AVOID "ANY CON-
SIDERABLE CHANGE" IN EFFECTIVE LIRA EXCHANGE RATE IN 1977
AND WOULD NOTE THAT (I) "CONSIDERABLE" CHANGE COULD TURN
OUT TO BE APPROPRIATE IN LIGHT OF RELATIVE WAGE/PRICE
DEVELOPMENTS (II), IF BY "CONSIDERABLE, SECRETARIAT MEANS
"EXCESSIVE" IN SENSE OF SUBSTANTIAL OVER-ADJUSTMENT OF
EXCHANGE RATE IN TERMS OF SOME MEASURE OF RELATIVE COM-
PETITIVITY, MISSION WOULD NOTE THAT ADHERENCE TO PRESENT
STABILIZATION PROGRAM WOULD MINIMIZE THAT POSSIBILITY;
(C) SECRETARIAT INDICATES THAT EFFECT OF DEPRECIATION ON
EXPORT VOLUMES WAS DILUTED BY GROWING TENDENCY OF ITALIAN
EXPORTERS TO FIX PRICES IN FOREIGN CURRENCY, AND STATES
THAT SOME QUALITATIVE EVIDENCE OF THIS EXISTS. MISSION
WOULD ASK SECRETARIAT TO ELABORATE ON THIS POINT; (D) IN
DISCUSSING MONETARY DEVELOPMENTS DURING 1976, SECRETARIAT
OBSERVES THAT BANKS WERE ABLE TO OBTAIN NEEDED LIQUIDITY
BY REDUCING THEIR HOLDINGS OF TREASURY BONDS. MISSION
WOULD SEEK ITALIAN DEL'S VIEWS ON HOW IMPORTANT SUCH
"VELOCITY EFFECTS" COULD BE IN THWARTING GOI EFFORTS TO

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PAGE 01 OECD P 04268 04 OF 04 101908Z
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LIMITED OFFICIAL USE SECTION 04 OF 04 OECD PARIS 04268

CONTROL GROWTH OF MONEY SUPPLY IN 1977; (E) SECRETARIAT STATES THAT SWITCH IN FEBRUARY, 1975, TO FLAT RATE WAGE INCREASES UNDER SCALA MOBILE WOULD HAVE EFFECT OF COM-
PRESSING WAGE DIFFERENTIALS. HOWEVER, SECRETARIAT INDICATES THAT WAGE DIFFERENTIALS HAVE BEEN OFTEN ESTABLISHED AND MAINTAINED UNDER PREVIOUS INDEXATION SYSTEM THROUGH AGREEMENTS REACHED AT PLANT LEVEL AND DOES NOT CITE CHANGES WHICH WOULD REDUCE THIS POSSIBILITY UNDER NEW SYSTEM. THUS, EFFORT TO MAINTAIN WAGE DIFFERENTIALS COULD CONSTITUTE ADDITIONAL INFLATIONARY IMPULSE. IN NEW MEASURES ANNOUNCED FEBRUARY 4, GOI HAS APPARENTLY TAKEN STEPS TO MINIMIZE THIS PROBLEM (I.E., PARA 4, REF B), MISSION WOULD RAISE THESE POINTS IN REVIEW; (F) REB B INDICATES THAT GOI WILL UNDERTAKE REVIEW BY JULY 1 TO SEE WHETHER STABILIZATION MEASURES ARE HAVING DESIRED EFFECT AND TO DETERMINE WHETHER ADDITIONAL CORRECTIVE STEPS ARE IN ORDER. MISSION WOULD QUESTION ITALIANS CONCERNING CRITERIA THAT MIGHT BE USED IN EVALUATION PROCESS AND WOULD ASK ITALIANS TO INDICATE WHAT
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PAGE 02 OECD P 04268 04 OF 04 101908Z

NATURE OF ADDITIONAL MEASURES WOULD BE; (G) MISSION WOULD SEEK ITALIAN ESTIMATES OF EFFECT ON LABOR COSTS OF JANUARY AGREEMENT BETWEEN BUSINESS AND LABOR AND OF MEASURES ANNOUNCED IN EARLY FEBRUARY.
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